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Further evidence on the ethics of managing earnings: an examination of the ethically related judgments of shareholders and non-shareholders

Steven E. Kaplan *

School of Accountancy and Information Management, Arizona State University, Tempe, AZ 85287, USA

Abstract

The current experimental study examines whether financial statement users' assessments of the ethicalness of earnings management is a function of intended benefit. Evening MBA students, assigned to the role of either a shareholder or non-shareholder, read three hypothetical scenarios involving a manager engaging in earnings management. In response to each scenario, participants judged the ethicalness of the earnings management incident and the likelihood that shareholders will suffer financially from the earnings management incident. The results of the study indicate that the ethicalness of earnings management was assessed less unethically for one of the three scenarios by shareholders when the earnings management was intended for company benefit. The results also show that intent did not influence ethicalness assessments among non-shareholders. These results provide some evidence to support Dye's (1988, pp. 201–207) analytic model and indicate that under certain conditions shareholders and non-shareholders are differentially influenced by the intent of earnings management. © 2001 Published by Elsevier Science Ltd.

1. Introduction

Companies as well as business-unit managers engage in earnings management (see Healy and Wahlen, 1999 for an excellent review), which can lead to a

* Tel.: +1-480-965-3631; fax: +1-480-965-8392.
E-mail address: steve.kaplan@asu.edu (S.E. Kaplan).

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variety of consequences. For example, while earnings management may allow management to achieve an earnings-based bonus, it may also effect management's reputation (Guidry et al., 1999, p. 120), and raise questions about management's ethics (Bruns and Merchant, 1990, p. 24). Indeed, Merchant and Rockness (1994, p. 92) characterize earnings management as "probably the most important ethical issue facing the accounting profession".

Merchant and Rockness (1994, pp. 87–90) provide initial evidence on the ethical assessments of earnings management among various organizational members (e.g., general managers, corporate staff, operating-unit controllers, and internal auditors). In this study I focus on assessments of those outside the organization – users of financial statements. Managers, companies, and policy makers should be interested in the extent to which external parties view earnings management activities as unethical. If earnings management is considered unethical by financial statement users, then managers' and companies' reputations may suffer and companies' credibility in the financial markets may be damaged. Beneish (1997, pp. 288–292) found, for example, that firms actually violating GAAP earn negative returns for two years following the disclosure of the GAAP violation. Similarly, Dechow et al. (1996, pp. 22–25) found that the stock market responds negatively to allegations of earnings management by the financial press or the Securities and Exchange Commission. Alternatively, the cost of capital may be higher among firms perceived as employing a management of questionable ethical standards. [1]

My paper provides evidence on the ethical judgments of earnings management by external parties. In particular, the paper develops hypotheses based on the idea that individuals reach egocentric or self-interested interpretations of ethics and fairness (Thompson and Loewenstein, 1992, pp. 178–179). In this regard, Thompson and Loewenstein (1992, p. 177) contend that individual's ethically related judgments "will be biased in a manner that favors themselves." Thus, users of financial statements are expected to assess earnings management as less unethical when they benefit from the earnings management.

I rely upon an analytic model developed by Dye (1988, pp. 201–207) to identify a situation in which certain users of financial statements benefit from earnings management. Dye's (1988, pp. 201–207) overlapping generations model contains two classes of financial statement users – shareholders and non-shareholders. The model indicates that shareholders have a demand for earnings management that boosts the share price in the short run (Dye, 1988, pp. 204–205). While managers engage in earnings management to increase the stock price, they also engage in earnings management for personal gain (Healy and Wahlen, 1999, p. 380). I refer to the former as company intent and the

[1] I wish to thank an anonymous reviewer for suggesting this possibility.

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